

Strothman & Company P S C

Certified Public Accountants & Advisors



Financial Statements

**Kentucky Higher Education
Student Loan Corporation**

June 30, 2006

Financial Statements

Kentucky Higher Education Student Loan Corporation

June 30, 2006

Independent Auditors' Report	1
Management's Discussion and Analysis (Unaudited)	2
Financial Statements	
Statement of Net Assets	8
Statement of Revenues, Expenses and Changes in Net Assets	9
Statement of Cash Flows	10
Notes to Financial Statements	12

Independent Auditors' Report

Board of Directors
Kentucky Higher Education Student Loan Corporation
Louisville, Kentucky



We have audited the accompanying financial statements of each major fund of the Kentucky Higher Education Student Loan Corporation (the "Corporation"), a component unit of the Commonwealth of Kentucky, as of and for the year ended June 30, 2006, which collectively comprise the Corporation's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of each major fund of the Corporation as of June 30, 2006, and the respective changes in financial position and cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis on pages 2 through 7 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 23, 2006, on our consideration of the Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements and other matters. The purpose of that report is to describe the scope of our testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

STROTHMAN & COMPANY P S C

Louisville, Kentucky
September 23, 2006

Management's Discussion and Analysis (Unaudited)

Kentucky Higher Education Student Loan Corporation

June 30, 2006

The Kentucky Higher Education Student Loan Corporation (the "Corporation") is an independent *de jure* municipal corporation established by the Kentucky General Assembly in 1978 to provide a loan finance program for post-secondary students in the Commonwealth of Kentucky (the "Commonwealth"). The Corporation functions as a lender of student loans, making loans to parents and students directly; a servicer of student loans; and a secondary market for the purchase of student loans from other lenders. The Corporation funds the origination or acquisition of these student loans by periodically issuing bonds and notes under various debt agreements, including its three general bond resolutions. The Corporation also services education loans and collects defaulted education loans. The Corporation's services and loans are marketed under the registered service mark "The Student Loan PeopleSM".

This section of the Corporation's annual financial report presents a discussion and analysis of the Corporation's financial performance for the fiscal year ended June 30, 2006. Please read it in conjunction with the Corporation's financial statements and the notes to the financial statements, which follow this section.

FINANCIAL HIGHLIGHTS AS OF JUNE 30, 2006

- The Corporation's total assets at year end were approximately \$1.8 billion, which is an increase of approximately \$364 million or 25% over the prior year.
- The Corporation's net student loans at year end were approximately \$1.5 billion, which is an increase of approximately \$278 million or 23% over the prior year.
- The Corporation's total revenue for the fiscal year ended June 30, 2006 was approximately \$149 million, which is an increase of approximately \$24 million or 19% from the prior fiscal year end.
- The Corporation's fee income for the fiscal year ended June 30, 2006 was approximately \$28 million, which is an increase of approximately \$5 million or 24% from the prior fiscal year end.
- The Corporation's interest expense for the fiscal year ended June 30, 2006 was approximately \$61 million, which is an increase of approximately \$31 million or more than double from the prior fiscal year end.
- The Corporation's total other operating expenses (excluding the provision for arbitrage liabilities and principal forgiveness) for the fiscal year were approximately \$65 million which is an increase of approximately \$13 million or 25% from the prior fiscal year end.
- The Corporation incurred approximately \$19.3 million in principal and interest forgiveness due to certain borrower benefit plans. This expense also reduced the excess yield on certain of the Corporation's outstanding bond obligations.

Continued

Kentucky Higher Education Student Loan Corporation

June 30, 2006

- During the year ended June 30, 2006, the Corporation transferred approximately \$59 million to the Commonwealth's General Fund in accordance with the requirements of the Commonwealth's approved Biennial Budget, and has additionally transferred approximately \$4.8 million to the Kentucky Higher Education Assistance Authority (the "Authority") to support programs that the Authority administers.
- The Corporation's change in net assets after operating transfers for the fiscal year ended June 30, 2006 was approximately \$52 million, which is a decrease of approximately \$65 million or more than five times greater than the prior fiscal year.

OVERVIEW OF THE FINANCIAL STATEMENTS

The Corporation's financial statements are prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP") as applied on an accrual basis. Under the accrual basis of GAAP, revenues are recognized in the period in which they are earned and expenses are recognized in the period in which they are incurred. These basic financial statements are separated into funds. These requirements, as well as certain governmental accounting pronouncements, require this financial statement presentation.

The three basic financial statements presented within the financial statements are:

Statement of Net Assets

This statement presents information regarding the Corporation's assets, liabilities and net assets. Net assets represent the total amount of assets less the total liabilities. The statement of net assets classifies assets, liabilities and net assets as current, noncurrent, restricted and unrestricted according to restrictions in each general bond resolution.

Statement of Revenues, Expenses and Changes in Net Assets

This statement presents the Corporation's interest income, cost of funds, operating expenses and changes in net assets for the fiscal year.

Statement of Cash Flows

The Corporation's statement of cash flows is presented using the direct method of reporting, which reflects cash flows from operating, investing, noncapital and capital financing activities.

Continued

Management's Discussion and Analysis (Unaudited)--Continued

Kentucky Higher Education Student Loan Corporation

June 30, 2006

FINANCIAL ANALYSIS OF THE CORPORATION

The Corporation's total net assets at June 30, 2006 were approximately \$61 million, which is a decrease of approximately \$52 million or 46% over June 30, 2005. Components of the Corporation's statement of net assets as of June 30, 2006 and 2005 were as follows:

	<u>2006</u>	<u>2005</u>	<u>Increase (Decrease)</u>	<u>%</u>
Assets				
Loans	\$ 1,485,239,206	\$ 1,207,632,746	\$ 277,606,460	23 %
Capital Assets	4,372,551	3,427,909	944,642	28 %
Other Assets	<u>322,597,586</u>	<u>237,502,856</u>	<u>85,094,730</u>	36 %
Total Assets	<u><u>\$ 1,812,209,343</u></u>	<u><u>\$ 1,448,563,511</u></u>	<u><u>\$ 363,645,832</u></u>	25 %
Liabilities				
Bonds/Notes Payable	\$ 1,697,250,000	\$ 1,297,250,000	\$ 400,000,000	31 %
Other Liabilities	<u>53,728,580</u>	<u>38,236,598</u>	<u>15,491,982</u>	41 %
Total Liabilities	<u>1,750,978,580</u>	<u>1,335,486,598</u>	<u>415,491,982</u>	31 %
Net Assets				
Invested in Capital	4,372,551	3,427,909	944,642	28 %
Restricted	41,368,483	89,201,746	(47,833,263)	(54) %
Unrestricted	<u>15,489,729</u>	<u>20,447,258</u>	<u>(4,957,529)</u>	(24) %
Total Net Assets	<u>61,230,763</u>	<u>113,076,913</u>	<u>(51,846,150)</u>	(46) %
Total Liabilities and Net Assets	<u><u>\$ 1,812,209,343</u></u>	<u><u>\$ 1,448,563,511</u></u>	<u><u>\$ 363,645,832</u></u>	25 %

The increase noted above in the Corporation's total assets is the continuation of a trend of growth in prior years. Total assets grew from approximately \$1.449 billion at June 30, 2005 to approximately \$1.812 billion at June 30, 2006. Net loans outstanding totaled \$1.485 billion at June 30, 2006, a \$278 million increase over June 30, 2005. This increase included \$618 million in loan acquisitions (both originations and purchases) offset by borrower payments, consolidation loan payments and principal forgiveness on the loans. Other assets increased by \$85 million as a result of increased cash, investment and accrued interest income balances at year end. These balances increased due to higher amounts of borrower payments from a maturing loan portfolio as more borrowers enter repayment, external consolidation payoffs and higher interest rates. During fiscal year 2006, the Corporation drew down approximately \$92 million from the 2000 Line of Credit which was fully repaid during the fiscal year. The Corporation also issued \$400 million in bonds to acquire student loans. This increase was the largest component of the Corporation's increase in its total liabilities. Other liabilities increased \$15.5 million, primarily as a result of a \$16.9 million increase in accounts payable and accrued expenses due to consolidation payoffs on third-party serviced loans partially offset by a decrease in the allowance for arbitrage liabilities.

Continued

Management's Discussion and Analysis (Unaudited)--Continued

Kentucky Higher Education Student Loan Corporation

June 30, 2006

The estimate of the Corporation's arbitrage liability is computed by an outside company who specializes in this area. At June 30, 2005, the Corporation's allowance for arbitrage liabilities was reported as being approximately \$29.9 million. In January 2006, the arbitrage specialist reported that a different bond yield assumption should have been used in conjunction with the computation of the Corporation's arbitrage liability estimate as of June 30, 2005. In addition, certain expenses were excluded from the computation that should have been considered. As a result, the arbitrage estimate as of June 30, 2005 should have been \$24.8 million. Net assets as of the beginning of the year have been increased by \$5.1 million to account for the above matter.

The Corporation's change in net assets for the year ended June 30, 2006 was \$51.8 million, which is a decrease of approximately \$65 million or 507% less than the change in net assets for the year ended June 30, 2005. Components of the Corporation's statements of revenues, expenses and change in net assets as of June 30, 2006 and 2005 were as follows:

	<u>2006</u>	<u>2005</u>	<u>Increase (Decrease)</u>	<u>%</u>
Revenues				
Interest on Loans	\$ 108,926,860	\$97,071,590	\$ 11,855,270	12 %
Interest on Investments	<u>12,092,096</u>	<u>5,218,632</u>	<u>6,873,464</u>	132 %
Total Interest Income	121,018,956	102,290,222	18,728,734	18 %
Fee Income	<u>28,140,159</u>	<u>22,746,230</u>	<u>5,393,929</u>	24 %
Total Revenues	149,159,115	125,036,452	24,122,663	19 %
Expenses				
Interest on Debt	60,950,730	30,365,717	30,585,013	101 %
Provision for Arbitrage	(3,062,910)	4,427,358	(7,490,268)	(169) %
Principal Forgiveness	14,296,168	10,597,487	3,698,681	35 %
Other Operating Expenses:				
Financing and Origination	10,448,071	8,211,301	2,236,770	27 %
Federal Consolidation	4,383,895	3,237,957	1,145,938	35 %
Personnel and	18,048,653	13,950,422	4,098,231	29 %
General Administrative	<u>32,180,967</u>	<u>26,563,675</u>	<u>5,617,292</u>	21 %
Total Other Operating Expenses	<u>65,061,586</u>	<u>51,963,355</u>	<u>13,098,231</u>	25 %
Total Expenses	<u>137,245,574</u>	<u>97,353,917</u>	<u>39,891,657</u>	41 %
Changes in Net Assets Before Operating Transfers	11,913,541	27,682,535	(15,768,994)	(57) %

Continued

Management's Discussion and Analysis (Unaudited)--Continued

Kentucky Higher Education Student Loan Corporation

June 30, 2006

	<u>2006</u>	<u>2005</u>	<u>Increase (Decrease)</u>	<u>%</u>
Transfers				
Transfer to the Authority	(900,000)	(4,651,055)	3,751,055	81 %
Transfer to the Kentucky National Guard Program	(3,859,691)	(2,500,000)	(1,359,691)	(54) %
Transfer to the Kentucky Treasury	<u>(59,000,000)</u>	<u>(7,800,000)</u>	<u>(51,200,000)</u>	(656) %
Changes in Net Assets	<u>\$ (51,846,150)</u>	<u>\$12,731,480</u>	<u>\$ (64,577,630)</u>	(507) %

Interest income, which includes interest on loans and investments, increased by 18% primarily due to higher loan volume in fiscal year 2006. Although interest rates were higher, the average yield from interest on loans decreased from 8.62% in fiscal year 2005 to 7.86% in fiscal year 2006 due to changes in legislation that lowered the amount of the special allowance subsidy received. Given the rising interest rate environment, investment yields increased from 1.71% in fiscal year 2005 to 3.82% in fiscal year 2006. Fee income was higher in fiscal year 2006 primarily due to the increase of consolidation services for a large client for whom the Corporation performs third-party servicing activities. Interest on debt more than doubled from the prior year due to rising interest rates on the variable rate bonds outstanding and higher bonds outstanding. Average rates rose from 2.30% in fiscal year 2005 to 3.82% in fiscal year 2006. Certain borrower benefits resulted in loan and interest forgiveness of approximately \$19.3 million which had the effect of reducing the excess yield on certain of the Corporation's outstanding bond obligations. Other operating expenses increased 25% due to costs related to the growing loan portfolio as the Corporation adds loan and servicing volume.

CONDITIONS AFFECTING FINANCIAL POSITION

At June 30, 2006, the Corporation was servicing and committed to purchase student loans from other lenders with a principal balance of approximately \$8.7 million. The total portfolio of student loans that the Corporation owns, services for other lenders, and collects was approximately \$7.96 billion at June 30, 2006. This is an increase of approximately \$820 million or 12% higher than as of June 30, 2005.

The Corporation continues to experience significant growth in all aspects of its operations. Efforts to increase the Corporation's lending market share in the Commonwealth and the continued rate of growth in the client servicing portfolio is expected to promote the sustained growth pattern for the Corporation throughout the coming fiscal year. The Corporation has added additional staff to perform the additional work associated with this significant growth.

Continued

Kentucky Higher Education Student Loan Corporation

June 30, 2006

Available and affordable funds from debt financings enable the Corporation to meet its lending demand for loans originated and purchased. Historically, the Corporation has issued primarily tax-exempt debt. However, since 1997 the Corporation has supplemented its tax-exempt funding with taxable debt at a higher interest cost. Annually, the Corporation receives an allocation from the Commonwealth's Private Activity Bond Allocation committee which authorizes the amount of tax-exempt debt that the Corporation can issue. As of June 30, 2006, the Corporation's tax-exempt debt outstanding was 40% of the total bonds outstanding. In addition to funds provided by debt issuances, the Corporation also has a \$100 million line of credit with Bank of America for loan acquisitions. This line of credit provides additional liquidity in the event that loan demand exceeds the available funds from debt issuances. The Corporation has secured this line of credit through December 31, 2006 and expects to renew or replace this funding source to ensure available funds throughout fiscal year 2007. The Corporation and its trustee monitor the maturities of all debt instruments and the appropriate levels in the debt service and debt service reserve accounts. There are no scheduled bond maturities in fiscal year 2007.

Certain loans financed through bonds dated prior to October 1, 1993 receive a 9.5% minimum rate of return based on provisions of the Higher Education Act of 1965, as amended and related interpretations by the USDE. However, beginning October 1, 2004, any new loans acquired or originated using the proceeds of tax exempt obligations originally issued prior to October 1, 1993, if either the underlying bonds are refunded or loans are refinanced, will no longer receive the 9.5% minimum rate of return. In addition, beginning February 8, 2006, any new loans acquired or originated using proceeds recycled from loans eligible for the 9.5% minimum rate of return will receive the usual special allowance rate paid on other loans, instead of the otherwise applicable rate of not less than 9.5% minus the applicable interest rate.

In October 2005, representatives of the USDE conducted a program review of the Corporation's FFELP portfolio. The review focused on the management of the portion of the FFELP portfolio financed with tax-exempt debt and the Corporation's compliance with related laws and regulations. A final report, issued in May 2006, found that certain of the Corporation's loans may qualify for additional special allowance from the USDE. Based on this USDE finding, management intends to analyze the applicable portion of its FFELP portfolio and file requests for additional special allowance. The amount of the special allowance receipts cannot be reasonably estimated at this time. Management intends to recognize special allowance revenues when the filing is accepted by the USDE.

The Corporation is scheduled to transfer funds to the Authority in support of various state tuition programs. Transfers of \$5,236,600 and \$6,095,000 will be made from released fund equity and net income during the years ending June 30, 2007 and 2008, respectively.

CONTACTING MANAGEMENT

This financial report is designed to provide the reader with a general overview of the Corporation's finances, and to show accountability for the money it receives. Inquiries about this report may be directed to the Financial Services Department, Kentucky Higher Education Student Loan Corporation, 10180 Linn Station Road, Suite C200, Louisville, Kentucky 40223.

Statement of Net Assets

Kentucky Higher Education Student Loan Corporation

June 30, 2006

	Education Finance Funds	Operating Fund	Combined Totals
Assets			
Current			
Cash and Cash Equivalents	\$ 205,475,948	\$ 28,004,987	\$ 233,480,935
Investments		10,500,310	10,500,310
Receivables and Prepaid Expenses	1,087	2,155,256	2,156,343
Accrued Interest Income	27,570,029	64,042	27,634,071
Special Allowance Receivable	13,128,145		13,128,145
Interfund Receivable (Payable)	1,349,628	(1,349,628)	
Total Current Assets	247,524,837	39,374,967	286,899,804
Noncurrent			
Loans, Net	1,485,239,206		1,485,239,206
Deferred Debt Issuance Cost	7,158,851		7,158,851
Deferred Loan Purchase Premiums and Origination Costs, Net	28,538,931		28,538,931
Property and Equipment, Less Accumulated Depreciation		4,372,551	4,372,551
Total Noncurrent Assets	1,520,936,988	4,372,551	1,525,309,539
Total Assets	\$ 1,768,461,825	\$ 43,747,518	\$ 1,812,209,343
Liabilities			
Current			
Accounts Payable and Accrued Expenses	\$ 3,610,673	\$ 23,619,852	\$ 27,230,525
Interest Payable	4,476,809		4,476,809
Due to Kentucky Higher Education Assistance Authority		265,386	265,386
Total Current Liabilities	8,087,482	23,885,238	31,972,720
Noncurrent			
Bonds/Note Payable	1,697,250,000		1,697,250,000
Allowance for Arbitrage Liabilities	21,755,860		21,755,860
Total Noncurrent Liabilities	1,719,005,860		1,719,005,860
Total Liabilities	1,727,093,342	23,885,238	1,750,978,580
Net Assets			
Invested in Capital Assets		4,372,551	4,372,551
Restricted	41,368,483		41,368,483
Unrestricted		15,489,729	15,489,729
Total Net Assets	41,368,483	19,862,280	61,230,763
Total Liabilities and Net Assets	\$ 1,768,461,825	\$ 43,747,518	\$ 1,812,209,343

See Notes to Financial Statements

Statement of Revenues, Expenses and Changes in Net Assets

Kentucky Higher Education Student Loan Corporation

Year Ended June 30, 2006

	Education Finance Funds	Operating Fund	Combined Totals
Revenues			
Interest on Loans	\$ 108,452,696	\$ 106,902	\$ 108,559,598
Late Payment Penalties	366,868	394	367,262
Interest on Investments	10,902,638	1,189,458	12,092,096
Debt Recovery Commission		31,106	31,106
Servicing Fees		10,054,981	10,054,981
Service/Administration Fees		18,054,072	18,054,072
Total Revenues	119,722,202	29,436,913	149,159,115
Expenses			
Interest on Debt	60,950,730		60,950,730
Amortization of Bond Issuance Costs	294,585		294,585
Variable Bond Credit Facility and Remarketing Fees	4,047,646		4,047,646
Provision for Arbitrage Liabilities	(3,062,910)		(3,062,910)
Amortization of Loan Purchase Premiums and Origination Costs	6,105,840		6,105,840
Depreciation and Amortization		2,168,806	2,168,806
Federal Consolidation Fees	4,383,895		4,383,895
Personnel and Professional Services		18,048,653	18,048,653
General Administrative		11,521,262	11,521,262
Provision for Student Loan Loss	(21,977)	(48,612)	(70,589)
Principal Forgiveness under Borrower Benefit Programs	14,296,168		14,296,168
Servicing and Administration Fees	18,054,072		18,054,072
Other Expenses	507,416		507,416
Total Expenses	105,555,465	31,690,109	137,245,574
Operating Income (Loss)	14,166,737	(2,253,196)	11,913,541
Transfers			
Interfund Transfers	(62,000,000)	62,000,000	
Transfer to the State Treasury		(59,000,000)	(59,000,000)
Transfer to the Kentucky National Guard Program		(3,859,691)	(3,859,691)
Transfer to the Kentucky Higher Education Assistance Authority		(900,000)	(900,000)
Decrease in Net Assets	(47,833,263)	(4,012,887)	(51,846,150)
Net Assets at Beginning of Year, as Restated	89,201,746	23,875,167	113,076,913
Net Assets at End of Year	\$ 41,368,483	\$ 19,862,280	\$ 61,230,763

See Notes to Financial Statements

Statement of Cash Flows

Kentucky Higher Education Student Loan Corporation

Year Ended June 30, 2006

	Education Finance Funds	Operating Fund	Combined Totals
Cash Flows From Operating Activities			
Principal Received on Loans	\$ 337,966,817	\$ 11,023	\$ 337,977,840
Interest on Loans	40,333,857	88,571	40,422,428
Special Allowance	47,329,559		47,329,559
Client Loan Receipts		2,119,284,609	2,119,284,609
Servicing Fees		10,284,202	10,284,202
Debt Recovery Commission/Cost Reimbursement		38,936	38,936
Loans Purchased, including Premiums	(12,498,946)	(13,468)	(12,512,414)
Loans Originated, including Costs	(619,750,228)		(619,750,228)
Interfund Loan Sales and Purchases	(69,782)	69,782	
Credit Facility Fees	(4,211,162)		(4,211,162)
Loan Receipts Remitted to Clients		(2,102,761,555)	(2,102,761,555)
Other Expenses	(22,270,473)	(5,900,664)	(28,171,137)
Net Cash Provided By (Used In) Operating Activities	(233,170,358)	21,101,436	(212,068,922)
Cash Flows From Investing Activities			
Investment Income	10,236,934	1,159,557	11,396,491
Proceeds from Sales and Maturities of Investments		16,400,000	16,400,000
Purchases of Investments		(20,237,978)	(20,237,978)
Net Cash Provided By (Used In) Investing Activities	10,236,934	(2,678,421)	7,558,513
Cash Flows From Noncapital Financing Activities			
Proceeds from Debt Issued	492,000,000		492,000,000
Debt Issuance Costs	(1,558,678)		(1,558,678)
Debt Principal Payments	(92,000,000)		(92,000,000)
Interest on Debt	(59,564,078)		(59,564,078)
Interfund Transfers	(62,000,000)	62,000,000	
Transfer to the State Treasury		(59,000,000)	(59,000,000)
Transfer to the Kentucky National Guard Program		(3,859,691)	(3,859,691)
Transfer to the Kentucky Higher Education Assistance Authority		(900,000)	(900,000)
Net Cash Provided By (Used In) Noncapital Financing Activities	276,877,244	(1,759,691)	275,117,553
Cash Flows From Capital and Related Financing Activities			
Property and Equipment Acquired		(3,400,931)	(3,400,931)
Net Cash Used In Capital and Related Financing Activities		(3,400,931)	(3,400,931)
Net Increase in Cash and Cash Equivalents	53,943,820	13,262,393	67,206,213
Cash and Cash Equivalents at Beginning of Year	151,532,128	14,742,594	166,274,722
Cash and Cash Equivalents at End of Year	\$ 205,475,948	\$ 28,004,987	\$ 233,480,935

Continued

Statement of Cash Flows--Continued

Kentucky Higher Education Student Loan Corporation

Year Ended June 30, 2006

	Education Finance Funds	Operating Fund	Combined Totals
Reconciliation of Operating Income (Loss) to Net Cash Provided By (Used In) Operating Activities			
Operating Income (Loss)	\$ 14,166,737	\$ (2,253,196)	\$ 11,913,541
Income and Expense Items not Affecting Cash Provided By (Used In) Operating Activities			
Investment Income	(10,236,934)	(1,159,557)	(11,396,491)
Depreciation and Amortization		2,168,806	2,168,806
Loss on Equipment Disposal		287,483	287,483
Amortization of Bond Issuance Costs	294,585		294,585
Amortization of Loan Purchase Premiums and Origination Costs	6,105,840		6,105,840
Interest on Debt	60,950,730		60,950,730
Provision for Loan Losses	(21,977)	(48,612)	(70,589)
Borrower Interest Converted to Principal	(16,753,612)	(18,725)	(16,772,337)
Principal Forgiveness	14,296,168		14,296,168
Interest Forgiveness	5,014,010		5,014,010
Net Change in Fair Value of Investments		1,662	1,662
Items Not Accounted for as Revenues or Expenses:			
Principal Received on Loans	337,966,817	11,023	337,977,840
Loans Purchased, including Premiums	(12,498,946)	(13,468)	(12,512,414)
Loans Originated, including Costs	(619,750,228)		(619,750,228)
Interfund Loan Sales and Purchases	(69,782)	69,782	
(Increase) Decrease in Assets:			
Receivables and Prepaid Expenses	3,573	5,503,203	5,506,776
Accrued Interest	(10,569,619)	(31,563)	(10,601,182)
Special Allowance Receivable	487,370		487,370
Interfund Receivable/Payable	(534,475)	534,475	
Increase (Decrease) in Liabilities:			
Accounts Payable and Accrued Expenses	1,042,295	16,050,123	17,092,418
Allowance for Arbitrage Liabilities	(3,062,910)		(3,062,910)
Net Cash Provided By (Used In) Operating Activities	\$ (233,170,358)	\$ 21,101,436	\$ (212,068,922)

See Notes to Financial Statements

Kentucky Higher Education Student Loan Corporation

June 30, 2006

Note 1--Description of Business and General Bond Resolutions

The Kentucky Higher Education Student Loan Corporation (the "Corporation") is an independent *de jure* municipal corporation established by the Kentucky General Assembly in 1978 to provide a loan finance program for post-secondary students in the Commonwealth of Kentucky (the "Commonwealth"). Governed by a Board of Directors, the Corporation is authorized to finance loans for students attending eligible post-secondary institutions, service and collect education loans, and issue bonds and notes not to exceed \$5 billion in order to carry out its corporate powers and duties. The Corporation's education finance, servicing and collection activities include: (i) the origination and secondary market acquisition of education loans originated pursuant to the Federal Family Education Loan Program ("FFELP"); (ii) the financing of FFELP Loans; (iii) the servicing of FFELP Loans and of other education loans, and (iv) the collection of FFELP Loans and other education loans for other holders on a commission or cost reimbursement basis. The FFELP student loans held, serviced and collected by the Corporation include Federal Stafford Loans ("Stafford"), Unsubsidized Stafford Loans ("Unsubsidized Stafford"), Federal Supplemental Loans for Students ("SLS"), Federal Parent Loans for Undergraduate Students ("PLUS"), and Federal Consolidation Loans ("Consolidations").

The FFELP loans held by the Corporation are primarily insured by the Kentucky Higher Education Assistance Authority (the "Authority"), as the state guaranty agency. Claims for death, disability or bankruptcy are 100% insured. For default claims filed before June 1, 2006, loans made prior to October 1, 1993 are 100% insured while those made on or after that date are 98% insured. On June 1, 2006, the Corporation was designated as an Exceptional Performer by the U. S. Department of Education ("USDE"). Default claims filed in June 2006 are eligible to receive 100% reimbursement. Effective July 1, 2006, default claims are 99% insured.

The Corporation's General Bond Resolutions ("GBR"s) and separate Series Resolutions for issue of revenue bonds contain provisions establishing funds and accounts for the segregation of assets and provisions restricting the use of the proceeds of bonds and other funds received.

As of June 30, 2006 the Corporation serviced approximately \$1.5 billion outstanding principal amount of FFELP Loans which are pledged pursuant to the 1983 GBR, the 1997 GBR, the 2000 Line of Credit Trust Agreement or the 2004 GBR and approximately \$6.3 billion of FFELP Loans and other education loans on behalf of other holders, including holders with national lending operations. The majority of such education loans are being serviced by the Corporation pursuant to servicing agreements. These agreements do not provide for the acquisition by the Corporation of the education loans serviced. As a servicer of FFELP loans, the Corporation collects student loan remittances and subsequently disburses these remittances to the appropriate lending entities. In addition, the Corporation currently collects approximately \$177 million of FFELP Loans and other education loans for other holders on a commission or cost reimbursement basis. The Corporation's obligations pursuant to such servicing and collection agreements are without recourse to assets pledged to collateralize any Corporation financings.

Kentucky Higher Education Student Loan Corporation

June 30, 2006

Note 2--Summary of Significant Accounting Policies

(a) Reporting Entity

The Corporation is a component unit agency of the Commonwealth of Kentucky and is reported as such in the Commonwealth of Kentucky Comprehensive Annual Financial Report.

(b) Basis of Presentation

The Corporation's basic financial statements are prepared in accordance with Governmental Accounting Standards Board ("GASB") Statement No. 34, *Basic Financial Statements and Management Discussion and Analysis - for State and Local Governments*. The basic financial statements are comprised of fund financial statements and notes to the financial statements. The fund financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America applicable to state government entities, which provide that financial activities operated similarly to private business enterprises be presented as separate proprietary funds and that accounting results be organized by funds to account for specific activities consistent with legal and operating requirements. The Corporation's funds include the Education Finance Funds and the Operating Fund. The Education Finance Funds include loan programs funded individually under financings under the 1983 General Bond Resolution, the 1997 General Bond Resolution, the 2004 General Bond Resolution and the Line of Credit.

Financial activities operated similarly to private business enterprises and financed through fees for servicing and defaulted loan collection are presented under the Operating Fund. The Corporation follows all applicable Governmental Accounting Standards Board pronouncements, as well as Financial Accounting Standards Board pronouncements and Accounting Principles Board Opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. The Corporation uses the accrual basis of accounting.

(c) Loan Losses

As discussed in Note 1, the Corporation's FFELP loans are guaranteed by the Authority. Management of the Corporation believes that the Authority will be able to honor all default claims submitted by the Corporation. However, the Corporation records a provision for loan losses based upon its expected default claims with respect to 99% insured loans and for loans with certain loan servicing violations. The allowance for loan losses on FFELP loans was \$750,751 for loan principal and \$166,446 for accrued interest as of June 30, 2006. Furthermore, the Corporation is required to purchase loans owned by third-party customers with certain loan servicing violations. As of June 30, 2006, the allowance for third-party servicing loan losses was \$1,576,772 for loan principal and \$241,387 for accrued interest.

(d) Investments

Investments, which consist principally of securities of the federal government or its agencies and commercial paper, are reported at fair market value. Fair market value is determined by using quoted market prices as of the last day of the fiscal year.

Continued

Kentucky Higher Education Student Loan Corporation

June 30, 2006

Note 2--Summary of Significant Accounting Policies--Continued

(e) Interest Income on Loans

The Corporation earns interest income on loans from three sources: (1) the USDE for subsidized interest earned while certain students are in school; (2) special allowance subsidies (discussed in Footnote 6); and (3) the borrowers. All interest is recorded when earned and is shown in the financial statements net of the interest related portion of the provision for loan losses.

(f) Servicing Fees

The Corporation's fees for servicing loans held by third parties are recorded as servicing fee revenue when earned. These third-party loans are not presented on the statement of net assets as they are not owned by the Corporation.

(g) Income Taxes

The Corporation is an independent *de jure* municipal corporation and political subdivision of the Commonwealth of Kentucky and is therefore not subject to federal or state income taxes.

(h) Deferred Bond Issuance Costs

Bond issuance costs are deferred and amortized over the life of the bonds, utilizing the bonds outstanding method, which approximates the effective interest method.

(i) Deferred Loan Purchase Premiums and Deferred Loan Origination Costs

Loan purchase premiums and certain origination costs are deferred and amortized over the estimated life of the loans acquired or originated, based on projected balances outstanding, which approximates the effective interest method.

(j) Interfund Eliminations

Receivables and payables among the funds of the Corporation are eliminated in the statement of net assets.

(k) Property and Equipment

Office furnishings, equipment, and system development costs are recorded at cost and depreciated over their estimated useful lives using the straight-line method.

(l) Statement of Cash Flows

For the statement of cash flows, the Corporation considers cash and cash equivalents to include money market funds and highly liquid investments which mature within one month of purchase.

Continued

Kentucky Higher Education Student Loan Corporation

June 30, 2006

Note 2--Summary of Significant Accounting Policies--Continued

(m) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Note 3--Cash, Cash Equivalents and Investments

The Corporation has adopted the provisions of GASB Statement No. 40, *Deposits and Investment Risk Disclosures*. This statement adds certain additional disclosures about cash and investments, including common areas of investment risk.

The Corporation's deposit and investment policy complies with the underlying bond resolution requirements. In accordance with those bond resolutions, all deposits and investments meet the requirements and approval of the line of credit and bond insurance providers. Additionally, such requirements mandate specific classes of investment vehicles including bank time deposits, certificates of deposit, direct obligations of the United States of America unconditionally guaranteed by the United States of America, indebtedness issued by certain Federal agencies, collateralized repurchase agreements or investment funds secured by obligations of the United States of America with collateral held by or at the direction of the trustee.

At June 30, 2006, the Corporation had \$233,480,935 of cash and cash equivalents. Of this amount, \$200,000 was covered by insurance provided by the Federal Deposit Insurance Corporation, \$6,641,050 was pledged with U.S. government obligations and \$6,026,911 was uninsured and uncollateralized. The remaining balance was invested in money market mutual funds, U. S. government obligations and repurchase agreements supported by U. S. government obligations.

At June 30, 2006, the Corporation had \$10,500,310 of investments, consisting of obligations of U.S. government sponsored agencies. The average effective duration (i.e. maturity) of the Corporation's portfolio is less than four months.

(a) Custodial Credit Risk – Deposits

Custodial credit risk is the risk that in the event of a bank failure, the Corporation's deposits may not be returned to it. The Corporation does not have a formal deposit policy for custodial credit risk, however, accounts are set up with overnight sweep accounts so that cash is invested in short term, liquid investments daily to minimize the amount of cash not covered by insurance provided by the FDIC.

Continued

Kentucky Higher Education Student Loan Corporation

June 30, 2006

Note 3--Cash, Cash Equivalents and Investments--Continued

(b) Custodial Credit Risk – Investments

For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the Corporation will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The Corporation's investments are held in the name of the Corporation by a trustee.

(c) Concentration of Credit Risk

The Corporation has no restrictions on the amount it may invest in any one issuer of the \$10,500,310 of investments. Approximately 72% of the Corporation's investments are in obligations of the Federal National Mortgage Association and 28% in obligations of the Federal Home Loan Mortgage Corporation.

(d) Interest Rate Risk

The Corporation does not have a formal policy limiting maturities of its investments (\$10,500,310 at June 30, 2006). However, as a matter of practice, the Corporation generally invests in instruments with a maturity of less than one year to manage its exposure to fair value losses from increasing interest rates,

Note 4--Loans

The Corporation originates, purchases and holds various types of student loans as described in Note 1. The terms of these loans, which vary on an individual basis depending upon loan type and the date the loan was originated, generally provide for repayment in monthly installments of principal and interest over a period of up to thirty years for Consolidation loans and generally up to ten years for other loans. The repayment period begins after a grace period of six months following graduation or loss of qualified student status for the Subsidized and Unsubsidized Stafford loans. The repayment period for Consolidation, SLS and PLUS loans begins on the date the loan is fully disbursed. Interest rates on student loans ranged from 2.875% to 12% for the fiscal year ended June 30, 2006 depending upon the type and date of origination of the individual loan.

Continued

Notes to Financial Statements--Continued

Kentucky Higher Education Student Loan Corporation

June 30, 2006

Note 4--Loans--Continued

Loans consist of the following at June 30, 2006:

Stafford – Subsidized	\$ 538,420,363
Stafford – Unsubsidized	410,124,080
PLUS/SLS	39,635,937
Consolidation	497,855,501
Other	<u>1,530,848</u>
 Total gross loans	 1,487,566,729
Allowance for loan loss	<u>(2,327,523)</u>
 Net loans	 1,485,239,206
Net deferred loan purchase premiums and origination costs	<u>28,538,931</u>

Net Loans and Deferred Loan Purchase Premiums and Origination Costs	<u>\$ 1,513,778,137</u>
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All student loans are initially guaranteed as to principal and accrued interest. In order for the loans to be or remain guaranteed, certain due diligence requirements in loan servicing must be met. As of June 30, 2006, \$2,320,938 of student loans were no longer considered guaranteed due to violation of due diligence requirements.

The Corporation withholds certain origination fees from the loan disbursements on FFELP loans to the borrowers and remits these fees to USDE. The amount of the origination fees is based on a percentage of the gross loan amount.

The Corporation is also required to pay to USDE certain lender and rebate fees. The amount of the Lender Fees is based on a certain percentage of the gross loan amount on all FFELP loans originated after October 1, 1993 and a certain percentage of the carrying value of the Consolidation loans.

Generally, all student loans of the Corporation are pledged as collateral for the various obligations of the Corporation.

Notes to Financial Statements--Continued

Kentucky Higher Education Student Loan Corporation

June 30, 2006

Note 5--Property and Equipment

A summary of Property and Equipment follows:

	Beginning Balance July 1, 2005	Additions	Disposals	Ending Balance June 30, 2006
Furniture	\$ 1,645,036	\$ 183,890	\$ 6,972	\$ 1,821,954
Computer Equipment	7,233,182	1,641,780	224,933	8,650,029
Other Equipment	257,111	70,103	11,568	315,646
System Development	55,955			55,955
Student Loan Servicing System	541,131			541,131
Debt Recovery System	139,350	567,294		706,644
Electronic Award Letter System		225,000		225,000
Electronic School Based Services System	223,000	458,263		681,263
Electronic Borrower Statements	100,000	254,600		354,600
Total Property and Equipment	10,194,765	3,400,930	243,473	13,352,222
Less Accumulated Depreciation	<u>6,766,856</u>	<u>2,454,805</u>	<u>241,990</u>	<u>8,979,671</u>
Net Property and Equipment	<u>\$ 3,427,909</u>	<u>\$ 946,125</u>	<u>\$ 1,483</u>	<u>\$ 4,372,551</u>

Note 6--Special Allowance

The U.S. Department of Education pays a special allowance to the Corporation after the end of each quarter representing supplemental interest on outstanding, insured loans. Certain FFELP loans disbursed during the period from January 1, 2000 through June 30, 2006 receive special allowance at a rate based upon the average of the bond equivalent rates of the 3-month commercial paper rate as reported by the U.S. Federal Reserve. Other eligible loans receive special allowance based on the 91-day U.S. Treasury bill rates. Certain loans financed through bonds dated prior to October 1, 1993 receive a 9.5% minimum rate of return based on provisions of the Higher Education Act of 1965, as amended, and related interpretations by the USDE. However, beginning October 1, 2004, any new loans acquired or originated using the proceeds of tax exempt obligations originally issued prior to October 1, 1993, if either the underlying bonds are refunded or loans are refinanced, will no longer receive the 9.5% minimum rate of return. In addition, beginning February 8, 2006, any new loans acquired or originated using recycled proceeds from loans eligible for the 9.5% minimum rate of return will receive the usual special allowance rate paid on other loans, instead of the otherwise applicable rate of not less than 9.5% minus the applicable interest rate.

Continued

Notes to Financial Statements--Continued

Kentucky Higher Education Student Loan Corporation

June 30, 2006

Note 6--Special Allowance--Continued

In October 2005, representatives of the USDE conducted a program review of the Corporation's FFELP portfolio. The review focused on the management of the portion of the FFELP portfolio financed with tax-exempt debt and the Corporation's compliance with related laws and regulations. A final report, issued in May 2006, found that certain of the Corporation's loans may qualify for additional special allowance from the USDE.

Based on this USDE finding, management intends to analyze the applicable portion of its FFELP portfolio and file requests for additional special allowance. The amount of the special allowance receipts that may be received from this is subject to uncertainty. As such, management intends to recognize special allowance revenues when the filing is accepted by the USDE.

Possible future changes in legislation and/or changes in USDE interpretations of laws and regulations could further affect loans which receive the 9.5% minimum rate of return. Such changes could be retroactive to prior years, but management does not expect this to be the case.

Note 7--Principal and Interest Forgiveness

During fiscal year 2006, the Corporation forgave \$14,296,168 in loan principal and \$5,014,010 in accrued interest for qualified borrowers that were teachers, nurses, and public service attorneys who worked in the Commonwealth and students who completed the academic period for which their loan was made.

Note 8--Revenue Bonds

The balance of revenue bonds at June 30, 2006 and the related activity for the year ended June 30, 2006 is as follows:

Series	Scheduled Maturity	Interest Rate	Beginning Balance July 1, 2005	Bond Maturities	New Issues	Ending Balance June 30, 2006
<u>1983 General Bond Resolution</u>						
1991 E	* December 1, 2011	Weekly	\$ 46,000,000			\$ 46,000,000
1996 A	* June 1, 2026	Weekly	25,000,000			25,000,000
2003 A	* December 1, 2032	Every 35 days	20,600,000			20,600,000

Continued

Notes to Financial Statements--Continued

Kentucky Higher Education Student Loan Corporation

June 30, 2006

Note 8--Revenue Bonds--Continued

<u>Series</u>	<u>Scheduled Maturity</u>	<u>Interest Rate</u>	<u>Beginning Balance July 1, 2005</u>	<u>Bond Maturities</u>	<u>New Issues</u>	<u>Ending Balance June 30, 2006</u>
<u>1997 General Bond Resolution</u>						
1997 A-1	May 1, 2027	Every 35 days	45,250,000			45,250,000
1997 A-2	May 1, 2027	Every 35 days	45,200,000			45,200,000
1997 B *	May 1, 2027	Every 35 days	44,550,000			44,550,000
1998 A-1	May 1, 2028	Every 28 days	36,400,000			36,400,000
1998 A-2	May 1, 2028	Every 28 days	36,400,000			36,400,000
1998 B *	May 1, 2028	Every 35 days	42,200,000			42,200,000
1999 A	May 1, 2029	Every 28 days	51,350,000			51,350,000
1999 B *	May 1, 2029	Every 35 days	23,650,000			23,650,000
2000 A-1	May 1, 2030	Every 28 days	42,100,000			42,100,000
2000 A-2	May 1, 2030	Every 28 days	42,100,000			42,100,000
2000 A-3	May 1, 2030	Every 35 days	42,050,000			42,050,000
2000 B *	May 1, 2030	Every 35 days	23,750,000			23,750,000
2001 A-1	May 1, 2031	Every 35 days	59,850,000			59,850,000
2001 A-2	May 1, 2031	Every 35 days	59,850,000			59,850,000
2001 B *	May 1, 2031	Every 35 days	30,300,000			30,300,000
2002 A-1	May 1, 2032	Every 28 days	55,450,000			55,450,000
2002 A-2	May 1, 2032	Every 35 days	55,450,000			55,450,000
2002 A-3 *	May 1, 2032	Every 35 days	39,100,000			39,100,000
2003 A-1 *	May 1, 2033	Every 35 days	63,700,000			63,700,000
2003 A-2 *	May 1, 2033	Every 35 days	16,950,000			16,950,000
<u>2004 General Bond Resolution</u>						
2004 A-1 *	June 1, 2034	Every 35 days	18,850,000			18,850,000
2004 A-2 *	June 1, 2034	Every 35 days	57,550,000			57,550,000
2004 A-3 *	June 1, 2034	Every 35 days	57,600,000			57,600,000
2004 A-4 *	June 1, 2034	Every 35 days	57,600,000			57,600,000
2004 A-5	June 1, 2034	Every 28 days	72,400,000			72,400,000
2004 A-6	June 1, 2034	Every 28 days	75,000,000			75,000,000
2004 B-1 *	June 1, 2034	Every 35 days	11,000,000			11,000,000
2005 A-1 *	June 1, 2035	Every 35 days			\$ 80,000,000	80,000,000
2005 A-2	June 1, 2035	Every 28 days			45,000,000	45,000,000
2005 A-3	June 1, 2035	Every 28 days			45,000,000	45,000,000
2005 A-4	June 1, 2035	Every 28 days			70,000,000	70,000,000
2005 A-5	June 1, 2035	Every 28 days			50,000,000	50,000,000
2005 A-6	June 1, 2035	Every 28 days			40,000,000	40,000,000
2005 A-7	June 1, 2035	Every 28 days			50,000,000	50,000,000
2005 B-1 *	June 1, 2035	Every 35 days			20,000,000	20,000,000
			<u>\$1,297,250,000</u>	<u>\$ -</u>	<u>\$ 400,000,000</u>	<u>\$ 1,697,250,000</u>

* This bond series is tax-exempt.

Continued

Notes to Financial Statements--Continued

Kentucky Higher Education Student Loan Corporation

June 30, 2006

Note 8--Revenue Bonds--Continued

All interest rates are variable interest rates that change based on specified indices.

Debt service requirements to maturity or redemption date, assuming interest rates on variable rate debt remains at June 30, 2006 levels, are as follows:

	Principal Repayment Amount (Thousands)			
	83 GBR	97 GBR	04 GBR	Total
5 Years Ending June 30, 2016	\$ 46,000			\$ 46,000
5 Years Ending June 30, 2021				
5 Years Ending June 30, 2026	25,000			25,000
5 Years Ending June 30, 2031		\$ 625,000		625,000
5 Years Ending June 30, 2036	20,600	230,650	\$ 750,000	1,001,250
	<u>\$ 91,600</u>	<u>\$ 855,650</u>	<u>\$ 750,000</u>	<u>\$ 1,697,250</u>
	Interest Payments Amount (Thousands)			
	83 GBR	97 GBR	04 GBR	Total
Year Ending June 30, 2007	\$ 3,297	\$ 35,698	\$ 32,009	\$ 71,004
Year Ending June 30, 2008	3,297	35,698	32,009	71,004
Year Ending June 30, 2009	3,297	35,698	32,009	71,004
Year Ending June 30, 2010	3,297	35,698	32,009	71,004
Year Ending June 30, 2011	3,297	35,698	32,009	71,004
5 Years Ending June 30, 2016	8,897	178,492	160,043	347,432
5 Years Ending June 30, 2021	8,208	178,492	160,043	346,743
5 Years Ending June 30, 2026	8,133	178,492	160,043	346,668
5 Years Ending June 30, 2031	3,708	124,707	160,043	288,458
5 Years Ending June 30, 2036	1,050	11,384	110,430	122,864
	<u>\$ 46,481</u>	<u>\$ 850,057</u>	<u>\$ 910,647</u>	<u>\$ 1,807,185</u>

All assets of the 1983 General Bond Resolution Fund and 1997 General Bond Resolution Fund and 2004 General Bond Resolution Fund are pledged for repayment of the specific bond issues under each resolution.

Note 9--Line of Credit

The Corporation is a party to a Line of Credit Agreement with Bank of America, N.A., providing for advances to the Corporation not to exceed an aggregate outstanding principal balance of \$100 million. The borrowing period ends December 31, 2006, and can be extended at the discretion of both parties through December 31, 2007. During the year ended June 30, 2006, the Corporation drew down \$92,000,000 and made principal payments of \$92,000,000 on this line of credit. At June 30, 2006, there were no advances outstanding.

Kentucky Higher Education Student Loan Corporation

June 30, 2006

Note 10--Allowance for Arbitrage Liabilities

Certain of the Corporation's tax-exempt bond issues subject the Corporation to potential arbitrage liabilities under U.S. tax law. Arbitrage liabilities under current federal income tax law regarding tax-exempt bond issues consist of three types; (1) yield adjustment payments, (2) forgiveness and (3) arbitrage rebate. At June 30, 2006, the Corporation is reporting a liability for yield adjustment payments and forgiveness of \$21,519,907 and for arbitrage rebate of \$235,954.

The determination of excess yield on acquired purpose investments is cumulative over the life of the applicable bond series, as is the determination of arbitrage rebate on non-purpose investments, except for variable rate bonds for which arbitrage rebate is generally determined for each five-year period without retroactivity.

Yield adjustment payments, which also relate to yield restriction on acquired purpose investments, are applicable to all tax exempt bonds. The allowable yield is 2% above the bond yield (arbitrage yield), with the federal special allowance included in income. The loss of tax-exempt status may be avoided by rebating the excess yield to the U.S. Treasury every 10 years, and upon final maturity of the bonds.

Forgiveness is applicable to all tax exempt bonds. In general, a yield restriction is imposed on acquired purpose investments, designating the allowable yield as 1.5% or 2.0% above the bond yield (arbitrage yield). The loss of tax-exempt status may be avoided by partial forgiveness of the applicable student loans. Forgiveness can be applied upon maturity of the bonds or as otherwise prescribed by the bond resolutions.

Arbitrage rebate is applicable to all of the Corporation's tax-exempt bonds. With certain limited exceptions, income earned on non-purpose investments (investments other than student loans), which exceeds the bond yield (arbitrage yield), must be rebated to the U.S. Treasury. Payments of at least 90% are due every five years after the year of issuance, and upon final maturity of bonds.

The estimate of the Corporation's arbitrage liability is computed by an outside company who specializes in this area. At June 30, 2005, the Corporation's allowance for arbitrage liabilities was reported as being approximately \$29.9 million. In January 2006, the arbitrage specialist reported that a different bond yield assumption should have been used in connection with the computation of the Corporation's arbitrage liability estimate as of June 30, 2005. In addition, certain expenses were excluded from the computation that should have been considered. As a result, this arbitrage liability estimate as of June 30, 2005 should have been \$24.8 million. Net assets as of the beginning of the year have been increased by \$5.1 million to account for the above matter.

Kentucky Higher Education Student Loan Corporation

June 30, 2006

Note 11--Credit and Liquidity Facilities and Bond Remarketing

The 1991 Series E and 1996 Series A Bonds are collateralized with Standby Bond Purchase Agreements, pursuant to which Landesbank Hessen-Thüringen Girozentrale will purchase any bonds not remarketed. The 1991 Series E Bonds and the 1996 Series A Bonds also have a Municipal Bond Insurance Policy issued by AMBAC Indemnity Corporation and MBIA Insurance Corporation, respectively, which collateralizes payment of principal and interest on the bonds. The Standby Bond Purchase Agreements expires December 1, 2011 for the 1991 Series E Bonds and December 31, 2015 for the 1996 A Bonds. The AMBAC Municipal Bond Insurance Policy extends through the term of the 1991 Series E Bonds, December 1, 2011 and the MBIA Municipal Bond Insurance Policy extends through the term of the 1996 Series A Bonds, June 1, 2026.

The Corporation pays certain fees with respect to its variable rate bonds to auction agents, broker dealers, market agents, remarketing agents, and tender agents for remarketing bonds or conducting auctions of bonds. These arrangements are generally cancelable with prior notice by either party.

Note 12--Retirement Plan

The Corporation provides retirement benefits to all full-time employees through the Kentucky Retirement System ("KRS"). KRS is a multiple-employer, defined benefit plan sponsored by the Commonwealth of Kentucky, which provides retirement, disability, and death benefits. The Corporation contributed 5.89% of gross wages for the year ended June 30, 2006. The employees contributed 5% of their gross wages to the plan for the year ended June 30, 2006. Such rates are intended to provide for normal costs on a current basis, plus an amount equal to the amortization of unfunded past service costs over thirty years, using the level percentage of payroll method. These contribution rates are determined by the Board of Trustees of KRS each biennium. The payroll of employees covered by the retirement plan was \$15,582,367 for the year ended June 30, 2006. Total payroll for the year ended June 30, 2006 was \$16,374,811. KRS participants have fully vested interests after the completion of sixty months of service, twelve months of which are current service. The KRS contribution requirement for the year ended June 30, 2006 was \$1,697,055, which consisted of employer contributions of \$917,875 and \$779,180 from employees in 2006. Employer contributions for the years ended June 30, 2005 and 2004 were \$729,919 and \$564,750, respectively. Although separate measurements of assets and pension benefit obligation are not available for individual employers, KRS's annual financial report (which is a matter of public record) contains this information for KRS as a whole. It may be obtained from the KRS by writing to them at 1260 Louisville Road, Perimeter Park West, Frankfort, Kentucky 40601.

Note 13--Related Party Transactions

The Corporation maintains a Board of Directors that mirrors the Authority's Board of Directors. In accordance with Kentucky Revised Statutes 164.746 and 164A.050, the Corporation and the Authority maintain a board comprised of ten members appointed by the Governor and five ex officio voting members. In addition, the Corporation and the Authority share certain key management personnel and services.

Continued

Kentucky Higher Education Student Loan Corporation

June 30, 2006

Note 13--Related Party Transactions--Continued

The Corporation has a shared services agreement with the Authority. Under this agreement, the Corporation performs certain services for the Authority, and vice versa. The agreement covers such areas as information processing services and technology, collection services, internal audit, executive management and professional support services, clerical administrative and technical support services, creative services, and cooperative procurement. During the year ended June 30, 2006, the Corporation provided net services to the Authority valued at \$4,504,000.

The Corporation also maintains a loan origination and disbursement services agreement with the Authority. During the year ended June 30, 2006, the Corporation paid the Authority \$767,753 for loan origination and disbursement services. As of June 30, 2006, the Corporation owed the Authority an additional \$208,307.

The Corporation reimburses the Authority for all direct postage charges related to the Corporation. The Corporation paid the Authority \$1,633,436 during the year ended June 30, 2006 for postage reimbursement. As of June 30, 2006, the Corporation owed the Authority an additional \$57,079.

During the year ended June 30, 2006, the Corporation transferred \$59 million to the Commonwealth's General Fund in accordance with the requirements of the Commonwealth's approved Biennial Budget, and has additionally transferred \$4,759,961 to the Authority to support programs that the Authority administers. Transfers to the Authority of \$5,236,000 and \$6,095,000 will be made from released fund equity and net income during the years ending June 30, 2007 and 2008, respectively.

Note 14--Net Assets

Restricted net assets consist of net assets of the Education Finance Funds as required by the 1983, 1997 and 2004 General Bond Resolutions, the separate Series Resolutions, and Line of Credit Agreements. Pursuant to action of the Board of Directors, unrestricted net assets at June 30, 2006 are reserved for the Corporation's operating expenses for the upcoming fiscal year.

Note 15--Operating Leases

The Corporation leases office space and equipment under agreements expiring through 2011. The following are the approximate minimum lease commitments under operating leases:

<u>Year Ending June 30</u>	
2007	\$ 883,000
2008	883,000
2009	861,000
2010	696,000
2011	615,000

Kentucky Higher Education Student Loan Corporation

June 30, 2006

Note 16--Commitments and Contingencies

The Corporation has entered into loan purchase contracts with various eligible lenders. Subject to the terms and conditions of these agreements, the Corporation on June 30, 2006, had plans to purchase a minimum of \$8.7 million of loans. The Corporation is subject to various claims and litigation in connection with the normal course of business. In the opinion of management, there are no matters which would have a significant adverse effect on the Corporation.

Note 17--Subsequent Events-2006 Bond Issue

On August 17, 2006, the Corporation issued \$350 million of Student Loan Revenue Bonds to continue its student loan finance program. The \$57.2 million 2006 Series A & B Tax Exempt Bonds are scheduled to mature on June 1, 2036, and bear interest rates that change every 35 days based on specified indices. The \$292.8 million 2006 Series A Taxable Bonds are scheduled to mature on June 1, 2036, and bear interest rates that change every 28 days based on specified indices.